Congress of the United States
Washington, DC 20515

February 27, 2003

The Honorable William Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Mr. Chairman:

We are writing to call your attention to a recent report by the staff of the Joint Committee on Taxation.[1] The report examined Federal tax issues arising out of the aggressive use of tax avoidance strategies by the Enron corporation.

The report makes it clear that Congress must take action to address aggressive corporate tax avoidance strategies. Our colleague, Congressman Doggett, has taken the lead on this issue in the House of Representatives. We are very pleased that Senators Grassley and Baucus now are supporting changes in substantive tax law and penalties to address these transactions. The analysis of the Joint Committee report provides ample support for their efforts.

However, the most disturbing aspects of the Joint Committee report involve matters that require action by the Securities and Exchange Commission, not the Congress. The Joint Committee report makes it clear that Enron engaged in some early transactions primarily for the tax benefits. However, Enron began reporting net operating losses for Federal income tax purposes even without the tax avoidance strategies. As a result, its need for tax savings diminished. At that time, Enron's tax department, in consultation with outside experts, began to enter into tax-related transactions that had "the primary purpose of manufacturing financial statement income." [2]

A brief description of two of the transactions described in the Joint

[1]Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issue, and Policy Recommendations (hereafter referred to as "Joint Committee Report"). The report (designated as JCS-3-03) is available online through the web page of the Joint Committee on Taxation.

[2] Joint Committee Report, p. 100.

Committee report will indicate why action by the SEC is required.

In 1997, Bankers Trust (now owned by Deutsche Bank) promoted a structured tax transaction to Enron called "Steele," for which Bankers Trust received at least $8.2 million in fees. In a letter describing the accounting treatment to Mr. William S. McKee (a legal advisor on the transaction), Bankers Trust made it clear that a corporation would pay only a small fee for the tax benefits of the transaction.[3] That fact is not surprising since the transaction would not give rise to significant cash benefits until the out years of the transaction, years eleven through twenty.[4]

However, Bankers Trust also made it clear that a corporation would pay a large fee for the transaction if it were structured to create short-term, pre-tax earnings. The Steele transaction was marketed to Enron as creating $120 million in pre-tax earnings over the first five years of the transaction even though significant cash benefits would not be realized until year eleven. The pre-tax earnings arguably were derived by treating the transaction as a "bargain purchase," even though Bankers Trust was quite explicit in the letter to Mr. McKee that there was "no bargain purchase from an economic perspective." Quite simply, Bankers Trust, with Mr. McKee's assistance, designed a transaction for Enron that artificially created $120 million in pre-tax earnings over five years by creating tax benefits that Bankers Trust recognized had little or no present value because of the long delay before they would come into effect.

Bankers Trust also promoted another similar, but even larger transaction to Enron called "Cochise," again with Mr. McKee's assistance, netting Bankers Trust $11.2 million in fees. Both Steele and Cochise purported to create pre-tax operating earnings, enabling Enron to overstate its operating income, not merely show a reduction in its effective tax rate. Bankers Trust recognized that Enron would pay it a large fee for the earnings overstatement that the orchestrated transaction manufactured.

Another transaction demonstrating how Bankers Trust and its legal advisors created artificial accounting benefits for Enron is the "Teresa" transaction marketed to Enron by Bankers Trust in 1997, and earning Bankers Trust over $8.8 million in fees. Teresa was designed to provide Enron with financial accounting income of over $200 million even though it involved a voluntary prepayment of Federal income tax by Enron, in return for tax benefits to be

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[3]Letter appears in appendix B of Joint Committee Report, beginning on p. B-181.

[4]See analysis on p. B-189.

recognized over a forty-year period.

Enron analyzed the tax benefits of the Teresa transaction on a present value basis using a seven percent discount rate, its internal hurdle rate for investment. Using that discount rate, the present value of the tax reductions from the Teresa transaction was less than the present value of the voluntary prepayments of Federal income tax that Enron made in that transaction.[5] In fact, Mr. McKee's tax opinion supporting the transaction stated that certain anti-abuse rules would not apply because the transaction did not result in a net tax reduction on a present-value basis.[6]

Moreover, Bankers Trust touted the fact that Teresa was revenue neutral to the IRS in its promotion materials for the transaction and, thus, not likely to be challenged by the Internal Revenue Service.[7] It is clear that the transaction was designed for the sole purpose of artificially inflating Enron's accounting income. Any doubt about the purpose of the transaction is eliminated by Mr. McKee's tax opinion which states that the predominate purpose of the transaction "was to generate income for financial accounting purposes."[8] A more stark example of the abusive nature of the Enron structured transactions could not be imagined.

According to press reports, Merrill Lynch will pay fines totaling $80 million because of the SEC investigation of two transactions in which it participated that were designed to inflate Enron's earnings. We believe that the enforcement action was totally appropriate. Investment bankers and their advisors need to recognize that there is a downside to the business of assisting companies in artificially creating earnings to report to shareholders.

We would suggest that the Merrill Lynch transactions seem small in comparison to the financial overstatements facilitated by Bankers Trust and others in the case of the Enron collapse. We strongly urge you to review the Joint Committee report with care. We believe that it is urgent that you examine the transactions outlined in that report, and take any appropriate action you deem necessary, consistent with your responsibilities under the federal securities laws.

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[5]See p. B-107 of Joint Committee Report.

[6]See portion of tax opinion appearing on p. C-363.

[7]See portion of promotion materials on p. B-249.

[8]See p. C-362.

In conclusion, restoring investor trust in the financial markets should be your goal. Vigorous action against parties that facilitate corporate overstatements is absolutely required. We are hopeful that the SEC action in the Merrill Lynch transaction is merely a first step.

Sincerely,

HON. RICHARD E. NEAL

HON. EDWARD J. MARKEY